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In the Supreme Court

OF THE

United States

October Term, 1937

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

vs.

ELBE OIL LAND DEVELOPMENT COMPANY,

Respondent.

Petition For Rehearing, or For Amendment of the Judgment of This Court Herein Granting Respondent Leave to Apply to the Board For Opportunity to Establish Additional Facts Which Would Affect the Result.

Respondent petitions this Court for a rehearing in this cause, or for amendment of the judgment of this Court herein granting respondent leave to apply to the Board for opportunity to establish additional facts which would affect the result. All three reasons submitted below are submitted as ground for rehearing, and the third reason is also submitted as ground for the amendment of judgment.

Jurisdiction

The judgment of this Court herein was entered March 7, 1938. This petition is filed within less than twenty-five days thereafter, under Rule 33 (28 U. S. C. A. ¶354).

REASONS SUBMITTED

A. For Granting a Rehearing

I. There is a clear conflict within the opinion of this Court rendered herein, and eliminating this conflict the opinion in itself supports respondent instead of the Government.

II. This Court has erroneously assumed that the net income is something wholly distinct from the gross income, instead of, as it is, a part of the gross income itself.

B. For Granting a Rehearing or Amendment of Judgment

I. The decision of this Court is based upon a mixed issue of law and fact not raised at all before the Board, nor before the Court below, nor fairly raised in the Government's petition or brief filed in this Court.

DISCUSSION OF REASONS FOR GRANTING A REHEARING

I.

There is a Clear Conflict Within the Opinion of This Court Rendered Herein, and Eliminating This Conflict the Opinion in Itself Supports Respondent Instead of the Government.

The decision rendered by this Court rests entirely upon the following three propositions:

1. That respondent made "an absolute sale of all the properties in question, including all the oil and gas in place."

2. That with respect to the same specific properties, after Honolulu had been fully reimbursed as provided in the agreement, respondent was to "receive monthly one-third of the net profits resulting from the production and operation."

3. That such provision entitling respondent to a share of the net profits was "a personal covenant of the Honolulu Company" giving the respondent no "equitable interest in the *res*."[1]

It is submitted that the above three propositions cannot stand together. If, in accordance with the *first* proposition, the transaction constituted an absolute sale to Honolulu of "all the properties in question, including all the

[1]The quotation, "equitable interest in the *res*," is taken from *Helvering v. O'Donnell*, No. 406, cited by the Court on this point.

oil and gas in place," then Honolulu could in turn sell all the oil and gas in place to a third party. Suppose Honolulu did so sell all the oil and gas in place to a third party. If now respondent's right, conceded under the *second* proposition, to a share in the "net profits from the production and operation," was, in accordance with the *third* proposition, a "personal covenant of the Honolulu Company" giving respondent no "equitable interest in the *res,*"—then respondent would have to look to Honolulu for net profits from the production and operation of properties in which Honolulu had no right, title or interest, as to which, in fact, Honolulu had no right even to know what the net profits were. Such a result would make of respondent's right to net profits a nullity and an absurdity. May we then quote again, as we did in oral argument, from Cardozo, Chief Judge, in *Outlet Embroidery Co. v. Derwent Mills*, 254 N. Y. 179, 172 N. E. 462, 70 A. L. R. 1440 (at page 463, N. E.):

> "To read the reservation thus is to rob it of its efficacy as an implement to be used in furtherance of a business purpose. In the transactions of business life, sanity of end and aim is at least a presumption, albeit subject to be rebutted. The defendant like the plaintiff supposed that in signing these documents it was doing something understood to be significant and serious. * * * Was it all sound and fury, signifying nothing?
>
> "If literalness is sheer absurdity, we are to seek some other meaning whereby reason will be instilled and absurdity avoided. * * * In the setting of the occasion, no other interpretation was possible for any reasonable mind."

Thus we are led inescapably to the conclusion that respondent's right to share in the net profits from production and operation was, because of the very nature of the right itself, at least an equitable interest in the *res*. Of the three propositions shown above, then, as derived from this Court's opinion, the second stands in necessary conflict with the other two. Respondent suggests that this conflict within the opinion of this Court herein has resulted from its effort to restrict the "economic interest" doctrine of *Palmer v. Bender*, 287 U. S. 551, to ownership recognizable at law or in equity, and at the same time set up its own criteria of such ownership so as to avoid the variations, if any, of local law. This is impossible, since such ownership is determined wholly by the law of the situs. If, according to the law of the situs, a person has no rights in a piece of property, this Court cannot give him any, nor if he has such rights can this Court deny their existence. For that reason this Court has consistently held that with respect to ownership, or property rights generally, decisions of the courts of the State of situs, particularly of the highest court of such State, are binding upon this Court.

Spindle v. Shreve, 111 U. S. 542, 547, 548;
Uterhart v. United States, 240 U. S. 598, 603;
Poe v. Seaborn, 282 U. S. 101, 110;
Freuler v. Helvering, 291 U. S. 35, 45;
Blair v. Commissioner, 300 U. S. 5, 9, 10;
Sharp v. Commissioner, ... U. S. ..... (decided March 14, 1938).

It was because of this determinative effect of the law of the situs that respondent, the properties involved in the contract here being California property, cited twice in its brief a decision handed down only last year by the Supreme Court of California, *Schiffman v. Richfield Oil Co.*, 93 Cal. Dec. 114, 64 Pac. (2d) 1081, holding that a right to share in net profits of oil leases was enforceable in equity against the *res*. The record here shows that a portion of the properties were transferred by Honolulu to Shell (R. 65, 67-68). There is no provision in the contract for payment to respondent because of any such transfer; respondent's interest was, as this Court points out, in net profits from *production and operation*. If then Shell refused to account monthly to respondent, as required in the contract, and respondent thereupon sued Shell for an accounting, the State court would, pursuant to the *Schiffman* case, decree that the accounting be made. Could this Court deny the effect of such a decree? Because of this controlling effect of the *Schiffman* case, it was quoted from in oral argument at length. May we quote again:

(P. 1082 [Pac.]):

> "By said instruments the Monrovia Oil Company assigned to plaintiff stated percentages of the proceeds to be 'derived and received * * * from the sale or other disposal of sixty-six and two-thirds (66-2/3) per cent of net production' of the well which should remain after payment of expenses."

(P. 1083):

> "Defendant's further contention is that although the participating oil agreements are not the certifi-

cates of beneficial interest provided for by the trust, and plaintiff's rights are measured by the participating agreements alone, nevertheless said agreements created only the personal obligation of the Monrovia Oil Company, and did not give plaintiff any interest in oil produced after the Monrovia Company had assigned the sublease. We are in accord with the judgment of the trial court rejecting both these contentions."

(P. 1088):

"We are of the view that whether or not the royalty assignments in this case transferred to the holders thereof an interest in the leasehold, that is, in the profit *a prendre* to produce oil, in any event they vested in the holders a right to share in the proceeds of oil produced during the continuance of the lease by an assignee of the lease with notice."

(P. 1088):

"The rights of the holders of royalty assignments to an interest in the proceeds of oil produced by an assignee of the leasehold should not depend on whether the assignment is of a percentage of the oil 'to be produced, saved, and sold,' as in *Western Oil etc. Co. v. Venago Oil Corp., supra,* or is of a percentage of the net proceeds as in the instant case."

(P. 1089):

"It is certainly not within the contemplation of the royalty holder that in addition to the other risks involved, the lessee may at any time terminate the royalty holder's interest by assigning the lease, and leave the royalty holder remediless or with a claim for a share of the price received by the lessee for the

transfer of the leasehold, or a claim for monetary damages."

(P. 1089):

"Where royalty assignments are made by a lessee, the holders thereof have an interest in oil produced by an assignee of the leasehold covering the land from which the oil is to be produced who acquires the leasehold with notice, or in the proceeds thereof."

It may be observed that the next to the last passage quoted states the reason for the rule, the very point made above that the right to a share in net profits from production and operation would otherwise be a nullity. In addition to the *Schiffman* case, respondent cited *Akin v. Marshall Oil Co.*, 188 Pa. 602, 41 Atl. 748, which went so far as to hold (at p. 750) that where a lessee, as here, transfers the properties with a provision for payment to him of a share of the net profits, such provision is a covenant running with the land. No cases to the contrary were shown by the Commissioner here. Nor does this Court in its opinion herein cite any cases showing that by the contract here involved respondent reserved no equitable interest in the *res*. Perhaps, indeed, it does not deny that respondent reserved such an interest. It merely says (in No. 406, cited here on this point): "No trust was declared by which respondent could claim an equitable interest in the *res*." Of course, no trust was declared here *in haec verba;* but it is settled law, as was pointed out in oral argument, that a trust may be implied from reservations or other provisions in a contract. Says *Corpus Juris*, 65 C. J. 277, citing cases from many jurisdictions:

> "An express trust may be created, not only by deed or conveyance which expressly provides that the property conveyed shall be held for the beneficiary, but also by a deed or other transfer containing conditions, reservations, or other provisions sufficiently indicating an intention that the title shall be held in trust * * *."

Surely this Court does not mean that even though the taxpayer has an equitable interest in the *res*, it is not entitled to percentage depletion because the interest was not reserved by a declaration of trust *in haec verba*. This Court has said that taxation is eminently practical. *Tyler v. United States*, 281 U. S. 487, 503; *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 365. It has also said that taxation is not concerned with the refinements of title. *Corliss v. Bowers*, 281 U. S. 376. *A fortiori*, where the right created is necessarily an equitable interest in the *res*, not only because the law of the situs says that it is, but because by the very nature of the right itself it can otherwise have no sense at all, it cannot be brushed aside merely because the contract did not say, with respect to such right, "the parties hereby declare this to be a trust." If this Court is concerned by what the provision granting such right to the taxpayer did or did not "purport" (No. 406) to do, then surely it did not purport to be a sham and a deceit—a grant to one party to the contract of a right, subject to a power in the other party at will to destroy it.

The same conflict in the opinion of this Court appears therein in an additional aspect. The transaction, it says, was an "absolute sale." "The aggregate sum of $2,-

000,000," it says, "was paid as an agreed purchase price." The date of the transaction is given as October 3, 1927. The taxable years involved, however, are 1928 and 1929. If the "absolute sale," for an "agreed purchase price" of $2,000,000, took place in 1927, then on what theory is any part of such agreed purchase price income in 1928 and 1929? Or stated inversely, if the payments of $400,000 each in 1928 and 1929 were income in those years at all, on what theory were they income from a sale which took place in 1927? Although respondent was, in fact, on the accrual basis (R. 19-20), the result would be the same if they were on the cash basis. Only the installment basis permits treating the amounts received on a sale as income in the years received regardless of the year of sale—*Treasury Regulations* 74, Art. 354; and the deduction here of the entire cost in 1927, shown in the opinion, negatives any election of the installment basis, even if such election were possible here. On what theory then, if the amounts received in 1928 and 1929 were income in those years at all, were they income from an "absolute sale" which took place in 1927? If not income from a sale, then what were they income from if not from the property?

The inconsistency is obvious enough with respect to the so-called cash payments involved here; it is glaring when the payments to be made out of net profits are considered. An "absolute sale" is made in 1927. In May, 1938, say, a payment is received out of the net profits of production and operation during the preceding month. Such payment could not possibly be income before 1938; yet this Court says such income is derived from the sale com-

pletely made in 1927. And if not from the sale, what from if not from the property? This is but another aspect of the conflict in the opinion of this Court considered above. There can be no escape from the conclusion that an "absolute sale" of properties, and a provision for payment to the vendor of a share of the net profits of *production and operation,* are in necessary conflict with each other.

On the face of this Court's own opinion, we submit, eliminating the clear conflict therein shown above, respondent did reserve an equitable interest in the *res;* so that the opinion itself supports respondent instead of the Government.

II.

This Court Has Erroneously Assumed that the Net Income is Something Wholly Distinct From the Gross Income, Instead of, as It Is, a Part of the Gross Income Itself.

We submit the following truths to be self-evident:

1. Net profits, or net income, is that part of the gross income left after deducting expenses.

2. The gross income therefore includes the net income, and the net income is part of the gross income.

3. One who owns a share in the net income therefore owns *pro tanto* a share in the gross income.

The point made by this Court in *Helvering v. O'Donnell,* No. 406, that, "if there were no profits, nothing would be payable to him," is wholly irrelevant, since if there were no net profits no one would be entitled to per-

centage depletion. The statute expressly provides that the allowance "shall not exceed 50 per centum of the net income."[2] Therefore, if there is no net income, there is no allowance of percentage depletion to any one, no matter how great the gross income may be. If it be assumed that there is no net income, it might as well also be assumed that there is no gross income, as far as percentage depletion is concerned.

We submit that this Court erroneously assumed that the net income is something wholly distinct from the gross income, instead of, as it is, a part of the gross income itself.

DISCUSSION OF REASON FOR GRANTING A REHEARING OR AMENDMENT OF JUDGMENT.

I.

The Decision of This Court is Based Upon a Mixed Issue of Law and Fact Not Raised at All Before the Board, Nor Before the Court Below, Nor Fairly Raised in the Government's Petition or Brief Filed in This Court.

The keystone of this Court's opinion herein is that respondent did not retain an equitable interest in the *res*. This is obviously a mixed question of law and fact. That this issue was not presented to or considered by the Board is shown by the fact that on the basis of this issue

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[2]*Revenue Act of 1928*, C. 852, 45 Stat. 791, Sec. 114 (b) (3); set forth in full in Brief for Respondent, p. 30.

this Court reversed the Board in No. 406 and affirmed the Board here. Nor was it presented in any form before the Court below. Nor even before this Court was it fairly raised, although perhaps it lurked beneath the lines in the Government's brief. Respondent therefore submits that it would be unfair to it to conclude this cause without rehearing.

Respondent submits also that on this ground it should at least be granted leave to apply to the Board for opportunity to establish additional facts which would affect the result. Had the issue as to whether respondent reserved an equitable interest in the properties been raised before the Board respondent might have shown, for example, the interpretation placed upon the contract involved by the parties thereto, and by subsequent transferees of the leases transferred under the contract. It might have shown that such subsequent transferees recognized the equitable interest of respondent in the properties, and acted upon it, and accounted and still account monthly to respondent. It might have shown, moreover, that this accounting is the monthly accounting required by paragraph 9 of the contract (R. 59), so that this Court in its reference to paragraph 9 as only "relating to abandonment of the purchase and reconveyance" may have seriously misstated the provisions of the contract. Respondent might also have shown that even after the time for abandonment of the contract had passed, such subsequent transferees sought and secured respondent's approval of changes in the leases transferred to them.

Such interpretation by the parties affected by the contract was considered by this Court in *Thomas v. Perkins,*

301 U. S. 655, 659. Moreover, no matter how the language used may be understood, it can hardly be doubted that the view now expressed by this Court with respect to percentage depletion is a decided limitation on the "economic interest" doctrine announced in *Palmer v. Bender, supra.* Had the present view of this Court been known at the time this proceeding was before the Board, much additional evidence, in line with that indicated above, might have been introduced. That respondent should be granted leave to apply to the Board for opportunity to introduce such evidence, and such other evidence as might be pertinent, is shown in *Helvering v. Gowran,* 302 U. S. ..... (decided December 6, 1937), wherein this Court stated:

> "If the Court of Appeals had accepted the theory, it would have been open to the taxpayer to urge, in view of the new issue presented that he should have the opportunity to establish before the Board additional facts which would affect the result. As we accept the new theory, leave is granted to apply to the lower court for that purpose."

Conclusion

For the reasons stated above it is respectfully submitted that a rehearing should be granted, or at least that the judgment of this Court herein should be amended so as to grant respondent leave to apply to the Board for opportunity to establish additional facts which would affect the result.

GEORGE T. ALTMAN,
Attorney for Respondent.

CERTIFICATE

I, GEORGE T. ALTMAN, attorney for respondent in the within entitled action, hereby certify that the foregoing Petition is, in my judgment, well founded and is not interposed for delay.

GEORGE T. ALTMAN,
Attorney for Respondent.

P. 1.

SUPREME COURT OF THE UNITED STATES.

No. 446.—October Term, 1937.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Elbe Oil Land Development Company.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[March 7, 1938.]

Mr. Chief Justice Hughes delivered the opinion of the Court.

The question is whether certain payments received by respondent in the years 1928 and 1929 constituted "gross income from the property", within the meaning of that phrase as used in relation to oil and gas wells in Section 114 (b) (3) of the Revenue Act of 1928, so as to entitle respondent to the prescribed depletion allowance. The Circuit Court of Appeals, reversing the decision of the Board of Tax Appeals (34 B. T. A. 333), sustained ~~petitioner's~~ respondent's claim. 91 F. (2d) 127. Certiorari was granted (— U. S. —) because of an asserted conflict with the decision of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Fleming*, 82 F. (2d) 324.

Respondent is a California corporation which acquired certain properties consisting of oil and gas prospecting permits, drilling agreements, leases and equipment. Development work resulted in the discovery of oil. On October 3, 1927, respondent conveyed all its right, title and interest in the described properties to the Honolulu Consolidated Oil Company. The latter agreed to pay to respondent $350,000 upon the execution of the agreement and, if the Honolulu Company should not elect to abandon the purchase (in accordance with one of the stipulations), the additional sums of $400,000 in each of the years 1928, 1929 and 1930, and the further sum of $450,000 in 1931. After the time when the Honolulu Company had been fully reimbursed as provided in the agreement for all its expenditures in the acquisition, development and operation of the properties, respondent was to receive monthly one-third of the net profits resulting from the production and opera-

tion. After careful stipulations with respect to such reimbursement and the computation of net profits, the agreement provided:

"Anything in this agreement contained to the contrary notwithstanding, it is the intention of the parties to this agreement that the full ownership, possession and control of all the properties, the subject of this agreement, and of all of the personal property acquired and/or used on and in connection with the operation and development of the properties, the subject of this agreement, shall be vested in Honolulu, and Elbe shall have no interest in or to said properties or in or to any personal property used on or in connection with the operation or development of the said properties or in or to the salvage value of any thereof, except as provided by paragraph 9" [relating to abandonment of the purchase and reconveyance].

The first payment of $350,000 was received by respondent in 1927 and being greater than the cost of all the properties transferred, respondent reported as taxable income the difference between that cost basis and the amount received. In its income tax returns for the years 1928 and 1929, respondent reported the payments of $400,000 received in each of the years and claimed 27½ per cent. thereof as an allowance for depletion. This is the claim which has been sustained below.

We agree with the conclusion of the Board of Tax Appeals that the contract between the respondent and the Honolulu Company provided for an absolute sale of all the properties in question, including all the oil and gas in place, and that respondent did not retain any interest or investment therein. The aggregate sum of $2,000,000 was paid as an agreed purchase price to which was to be added the one-third of the net profits payable on the conditions specified. We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction as an absolute sale or was other than a personal covenant of the Honolulu Company. See *Helvering* v. *O'Donnell*, decided this day. In this view, neither the cash payments nor the agreement for a share of subsequent profits constituted an advance royalty, or a "bonus" in the nature of an advance royalty, within the decisions recognizing a right to the depletion allowance with respect to payments of that sort. Such payments are made to the recipient as a return upon his capital investment in the oil or gas in place. See *Burnet* v. *Harmel*, 287 U. S. 103, 111, 112; *Murphy Oil Company* v. *Burnet*, 287 U. S. 299, 302. Payments of the purchase price

which are received upon a sale of oil and gas properties are in a different category. The words "gross income from the property", as used in the statute governing the allowance for depletion, mean gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves. See *Darby-Lynde Company* v. *Alexander,* 51 F. (2d) 56, 59. We conclude that as respondent disposed of the properties, retaining no investment therein, it was not entitled to make the deduction claimed for depletion. *Palmer* v. *Bender,* 287 U. S. 551, 557; *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 321; *Thomas* v. *Perkins,* 301 U. S. 655, 661; *Helvering* v. *Bankline Oil Company, supra; Helvering* v. *O'Donnell, supra.*

The judgment of the Circuit Court of Appeals is reversed and the cause is remanded for further proceedings in conformity with this opinion.

It is so ordered.

Mr. Justice CARDOZO and Mr. Justice REED took no part in the consideration and decision of this case.

A true copy.

Test:

Clerk, Supreme Court, U. S.